IN THE

United States Court Of Appeals

FOR THE NINTH CIRCUIT

No. 21184

In the Matter of
FIKE PLUMBING & HEATING CO., INC.,
Bankrupt.

TUCSON HOUSE CONSTRUCTION COMPANY AND
ROBERT E. MCKEE GENERAL CONTRACTOR, INC.,
Appellants,

v.

WALTER E. FULFORD, as Trustee in Bankruptcy of
FIKE PLUMBING & HEATING CO., INC.,
Appellee.

On Appeal From the United States District Court for the District of Arizona

---

BRIEF OF APPELLANTS

JENNINGS, STROUSS,
SALMON & TRASK

By William F. Haug
T. Patrick Flood
111 West Monroe
Phoenix, Arizona 85003
Attorneys for Appellants

SUBJECT INDEX

TABLE OF CASES

STATUTES CITED

OTHER AUTHORITIES

IN THE

United States Court Of Appeals

FOR THE NINTH CIRCUIT

No. 21184

In the Matter of
FIKE PLUMBING & HEATING CO., INC.,
Bankrupt.

TUCSON HOUSE CONSTRUCTION COMPANY AND
ROBERT E. MCKEE GENERAL CONTRACTOR, INC.,
Appellants,

v.

WALTER E. FULFORD, as Trustee in Bankruptcy of
FIKE PLUMBING & HEATING CO., INC.,
Appellee.

On Appeal From the United States District Court for the District of Arizona

---

BRIEF OF APPELLANTS

JURISDICTIONAL STATEMENT

This is an appeal from the Order Affirming Referee's Order entered on May 20, 1966, by the United States District Court for the District of Arizona (R. 155).[1] The underlying action was

---

[1] The record in this case consists of a volume of Court filings entitled Transcript of Record plus two reporters' Transcripts of Hearings. The Transcript of Record has been numbered consecutively from the first page through the last so that, e.g., an item on page 150 will be cited "R. 150."

brought by the trustee on a petition for turnover order before the Referee in Bankruptcy (R. 1), which petition was subsequently amended (R. 40). The trustee's petition was at all times resisted by the appellants herein, who filed a motion to dismiss the Order to Show Cause Why Turnover Order Should Not Be Entered (R. 4). It was contended by the trustee that the Bankruptcy Court had jurisdiction under 11 U.S.C. Sec. 11, and appellants in subsequent oral argument before the District Court consented to the summary jurisdiction of the Bankruptcy Court in order that this case might be decided upon its merits.

On June 8, 1965, the Referee entered an order taking appellants' motion to dismiss under advisement (R. 38). A hearing was held on these matters September 20, 1965 (T. I),[2] and final arguments were heard on November 5, 1965 (T. II). On March 16, 1966, the Referee in Bankruptcy granted the trustee's petition for turnover order (R. 67). Appellants then filed a Petition for Review in the United States District Court for the District of Arizona (R. 76). After a hearing was held in the District Court on April 29, 1966,[3] on May 20, 1966 the District Court entered an order affirming the Referee's order (R. 155). The District Court had jurisdiction to review the Referee's order under 11 U.S.C. Sec. 11.

This appeal from the Order Affirming Referee's Order (R. 155) was taken May 31, 1966, appropriate bond being filed the same day (R. 157, 158). This Court has jurisdiction under 11 U.S.C. Sec. 47.

STATEMENT OF THE CASE

This is a suit brought by the trustee on a petition for turnover

---

[2] The record contains two transcripts of proceedings. The transcript of proceedings of September 20, 1965 will hereinafter be designated as T. I; the transcript of the final argument of November 5, 1965 will hereinafter be designated as T. II.

[3] There is no transcript of proceedings available for this hearing.

order to recover the sum of $59,587.45 which the trustee claimed belonged to the bankrupt estate.

A. The facts of this case.

On November 17, 1964, Fike Plumbing & Heating Co., Inc. was adjudicated a bankrupt on a voluntary petition (R. 1, 40). Prior to its adjudication, Fike had been engaged in the business of a plumbing subcontractor.

On August 6, 1962 Fike entered into a subcontract (Trustee's Exhibit 3)[4] with the Tucson House Construction Company for the performance of plumbing work on the Tucson House, an apartment building under construction in Tucson, Arizona. The prime construction contract for the Tucson House project (Trustee's Exhibit 1) was between Tucson Title Insurance Company, legal owner under Trust No. 10578 with the equitable owners initially being Bernard W. Robbins and Raymond S. Schiff, and Tucson House Construction Company, an alleged joint venture composed of Robert E. McKee General Contractor, Inc., Robbins and Schiff.

As a practical matter, however, McKee was the general contractor (T. I 5), and the "joint venture" agreement (Trustee's Exhibit 2) was not entered into for the purpose of creating such an entity, but was for the purpose of giving Robbins and Schiff an identity of interest with the contractor, McKee, in order to obtain more favorable F.H.A. financing (T. I 54-57). Most of the elements required for the forming of a joint venture were not present (R. 28-31), and in addition, the agreement provided that McKee would guarantee the construction of the project at a fixed price, that McKee would have complete control, and would indemnify Robbins and Schiff from claims such as Fike's (T. I 57-64). The agreement was nothing more than a contract between

[4] There were a number of exhibits introduced in evidence at the September 20, 1965 hearing which are a part of the record on appeal. These will be identified by the exhibit number affixed to it at the hearing in the Bankruptcy Court. See Appendix A to his Brief for a full list of the exhibits.

Robbins and Schiff, as the owners, and McKee, as general contractor, which outlined their contractural arrangement. It did, however, have the effect of making Robbins and Schiff also liable with McKee for the payment of the subcontract price. National Surety Company was Fike's surety on its subcontract bond (Trustee's Exhibit 4) to Tucson House Construction Company.

The subcontract on the Tucson House project provided, among other things, that Fike would pay for all of its labor and materials and guaranty its work to be free from defects for a period of one year from the date of acceptance by the owners of the completed contract (Paragraph 27 of Trustee's Exhibit 3). The subcontract also provided that the final retention monies owing to Fike would not become due until "30 days after completion and acceptance of subcontractor's work by the owners and receipt of final payment from the owners." (Page 1 of Trustee's Exhibit 3; T. 16-7, 31).

While Fike was performing this contract, it entered into another subcontract (Respondent's Exhibit 8) on June 5, 1963 to perform plumbing work on the John C. Lincoln Hospital in Phoenix, Arizona. This subcontract was with the McKee corporation individually as contractor. Fike's surety on this subcontract was Reliance Insurance Company which is the successor in interest to Standard Accident Insurance Company (Trustee's Exhibit 5). The subcontract provided, among other things, that Fike would pay for all its labor and materials used on the project and would indemnify McKee from any and all liability, damage, claims and expenses resulting directly or indirectly from the performance of the contract.

By the terms of McKee's contract (Respondents' Exhibit 7) with the owner, John C. Lincoln Hospital, Inc., McKee became obligated to pay all claims on the Lincoln Hospital project. In order to insure this, the owner required McKee to furnish a bond (Respondents' Exhibit 7) by which McKee and its surety, General Insurance Company of America, became jointly and sever-

ally liable for unpaid claims for labor and materials on the Lincoln Hospital Project, including that furnished to Fike under its subcontract.

Fike was formally declared to be in default on the Lincoln Hospital subcontract by McKee as of November 16, 1964 (Respondents' Exhibit 9; T. I 114), the day before Fike filed its bankruptcy petition. At the time of its default, Fike's portion of the work was not complete, and it owed materialmen, for materials used in the project, in excess of $50,745.12. McKee called upon Fike's surety, Reliance, to complete the contract and pay Fike's outstanding bills. Reliance agreed to and did complete Fike's work, but it refused to pay the outstanding bills, contending that McKee had an obligation to use the monies owing to Fike on the Tucson House project, by way of offset, to pay these bills (T. I 39, 117-118).

Fike had completed its work on the Tucson House project, except for the payment of some material bills and its guaranty under the subcontract, in January or February 1964 (T. I 64). Because Fike had not been fully paid, and at the request of McKee who was trying to obtain final payment from the owners (T. I 119), Fike, on August 24, 1964, filed a Notice and Claim of Lien on the Tucson House project in the office of the Pima County Recorder (Trustee's Exhibit 6). No copies of this lien were ever served upon the owners (T. I 123), as required by the Arizona statutes,[5] and neither the owners nor McKee became aware of the lien until December, 1964 (T. I 10, 120-123; Respondents' Exhibit 11).

At the time of Fike's default on the Lincoln Hospital project and its subsequent adjudication in Bankruptcy, there was still owing to Fike on the Tucson House subcontract some $59,587.45, although Fike was not yet entitled to this money (T. I 11, 33-34, 64-65). Fike's surety on this project, National Surety, directed McKee to withhold payment of this sum to Fike or the trustee until all of Fike's bills had been paid and its warranty obligations

[5] Arizona Revised Statutes, § 33-993.

had been performed (Respondents' Exhibits 1 & 2; T. I 65-70, 78).

The project was accepted by the owners (Robbins and Schiff) and final payment made to the Tucson House Construction Company account (McKee) on December 11, 1964 (T. I 12). In order to receive this money it was necessary for McKee to put up a lien bond (Respondents' Exhibit 12), protecting the owners and the mortgage company from any liability attending Fike's lien, which the trustee would not formally release (T. I 119-120). This was a requirement of the title insurance company, which would not issue a title policy without it, and without the title policy, final payment could not have been made.

The final monies on this contract were placed in the Tucson House Construction Company account in an El Paso bank (T. I 19-20). From this account, which was under the exclusive control of McKee, McKee paid its own bills, and the unpaid bills of Fike on the Tucson House project, amounting to $2,765.45, as well as other charges incurred by McKee in performing Fike's warranty obligations, which the Referee found to total $1,375.87 up to September 20, 1965, exclusive of the lien bond premium (Respondents' Exhibit 10; T. I 80-81, 115-117). Since that date and prior to the expiration of the one year warranty period (T. I 78), other charges have been made against this account for warranty obligations, which amounts have heretofore not been presented to the Court.

On February 19, 1965 McKee transferred from the Tucson House Construction Company account $50,745.12 to an account it had in its own name, and from this account it issued checks in payment of the majority (T. I 84) of Fike's obligations on the Lincoln Hospital project. In this manner McKee mechanically accomplished its set-off (T. I 29, 35-39, 43-44, 117-118).

b. The instant proceedings.

As noted, on the 16th day of March, 1965, the trustee filed his petition for turnover order and obtained the issuance of an

order directing McKee to show cause why all the monies remaining on Fike's contract on the Tucson House project should not be turned over to the Bankruptcy Court (T. 1). It was not until the 8th day of September, 1965, twelve days before the Referee's hearing, that the trustee saw fit to amend his petition to include Tucson House Construction Company as the other respondent (R. 40).

Evidence was presented before the Referee in a hearing on September 20, 1965 (T. I), and final argument by counsel was presented before the Referee on November 5, 1965 (T. II).

On March 16, 1966, the Referee entered his order directing turnover of the proceeds to the trustee (R. 67), and appellants promptly filed a Petition for Review (R. 76) by the District Court. A hearing was held before the District Court on April 29, 1966, and on May 20, 1966 the District Court entered its order affirming the Referee's order (R. 155). The District Court's order affirmed the Referee's order in toto.

This appeal followed.

SPECIFICATION OF ERRORS RELIED ON

1. The Referee and the District Court erred in granting the Trustee's Petition for Turnover Order, for the reason that appellants have a bona fide right of set-off.

2. The Referee and the District Court erred in that their Finding of Fact numbered 15, stating that the bankrupt did not default on the Lincoln Hospital project until after bankruptcy, and that the obligation to complete the unfinished job and to pay all unpaid charges with respect thereto was that of Reliance Insurance Company, was clearly erroneous; and they further erred in that they failed to include in the Findings of Fact or Conclusions of Law that Fike was obligated to McKee in connection with the Lincoln Hospital project.

3. The Referee and the District Court erred in Findings of Fact numbered 3, 5 and 14 to the extent that those findings declare

that a joint venture was formed, for the reason that such a finding amounts to a conclusion of law; and they further erred in apparently concluding that a "joint venture" had been formed, since the evidence clearly shows that a "joint venture" was never actually formed.

4. The Referee and the District Court erred in concluding that the debts in question are not mutual debts within the purview of Sec. 68 of the Bankruptcy Act, in view of the fact that the debts here in issue are Fike to McKee, and McKee (whether individually or severally) to Fike, *and they are mutual.*

5. The Referee and the District Court erred in apparently concluding that the set-off claimed by McKee, in its individual capacity, was against wrongfully obtained proceeds or trust proceeds, and could not be allowed, for the reason that the basis stated for said apparent conclusion was clearly inapplicable, and said apparent conclusion was not supported by the evidence.

6. The Referee and the District Court erred in that Finding of Fact numbered 11, that the owner was not prejudiced by the failure of the Notice and Claim of Lien to be served upon the owner, and Conclusion of Law 1(b), that appellants did not have a legal right to receive the proceeds in question from the owner by reason of said Notice and Claim of Lien having been filed, were clearly erroneous, in view of the fact that said lien was completely invalid.

7. The Referee and the District Court erred in concluding that appellants had no legal right to retain the retention proceeds for the life of Fike's warranty of good workmanship, in view of the fact that Fike was unable to perform its warranty obligations.

8. The Referee and the District Court erred in apparently concluding that McKee secured payment of its debts from property transferred to it subsequent to the filing of the bankruptcy petition, and in not allowing McKee's claim of set-off, in view of the fact that McKee owed and owned the debts in question prior to the act of bankruptcy.

9. The Referee and the District Court erred in apparently concluding that Reliance Insurance Company was the real party in interest herein, and in concluding that the subrogation rights of Reliance were material to arriving at a decision in this case, for the reason that Reliance's interest in this case is totally immaterial to the validity of McKee's right of set-off.

10. The Referee and the District Court erred in concluding that appellants' claim was limited to a credit of $2,765.45, stemming from payment of certain labor and supplier's claims, and to an additional sum of $1,375.87, stemming from payment of certain warranty items, in view of the fact that McKee has suffered additional warranty expenses on Tucson House.

11. The Referee and the District Court erred in allowing the trustee interest, on the sum ordered to be turned over, to run from January 11, 1965, for the reason that McKee had a right to retain the retention proceeds until at least December 11, 1965.

12. The Referee and the District Court erred in allowing the trustee $5,500 as a reasonable attorney's fee, for the reasons that there is no evidence in the record to support such an award, and that the Referee had no jurisdiction to make such an award.

SUMMARY OF ARGUMENT

The one overriding issue to be resolved in this case is whether or not McKee is entitled to the right of set-off on the several debts in question. The trustee has admitted that if McKee, in its individual capacity, has a right to set-off the obligation owed it by Fike on the Lincoln Hospital project against the retention proceeds on the Tucson House project, then appellants should prevail on this appeal.

It is appellants' position that Fike is obligated to McKee on the Lincoln Hospital project by virtue of: (1) McKee's contractual obligations with the hospital; (2) McKee's obligations under its performance bond, which allows Fike's suppliers to seek

redress directly from McKee without joining Fike; (3) Fike's obligations under its subcontract with McKee; and (4) the statutory right granted to Fike's surety under the laws of the State of Arizona. Thus, the debt owned by McKee is owned in its individual capacity.

In considering the obligations arising out of the Tucson House project, appellants first of all contend that no true joint venture or partnership was formed, and that McKee, individually, is obligated to Fike. If that be the case, then it is clear that we are dealing with mutual, individual debts between McKee and Fike, and the right of set-off is present.

However, should the Referee's apparent conclusion that a joint venture was formed be allowed to stand, it makes no difference under Arizona law, since McKee would be liable for the Tucson House obligation to Fike both jointly and severally. Appellants have cited case law directly in point which clearly demonstrates that a debt owed jointly and severally may be offset with a debt which is owned individually. Thus, the right of set-off is available to McKee, since it is attempting to set off a separate debt which it owes severally against a separate debt which it owns individually, and appellants should prevail.

ARGUMENT

1. McKee has a right to set-off the debt it owes in connection with Tucson House, with the debt it owns in connection with Lincoln Hospital.

Section 68 of the Bankruptcy Act governs the right of set-offs in bankruptcy proceedings, and Sec. 68(a) reads as follows:

> "In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set-off against the other, and the balance only shall be allowed or paid."

The above quoted section does not create any new right, but merely recognizes the existence of the doctrine of set-off, and provides a method whereby it can be enforced after bankruptcy.

The purpose of this section is to prevent a possible injustice which would result if a creditor were compelled to prove his claim in full and accept possible dividends thereon, and at the same time pay in full his indebtedness to the estate. It is clear, and both parties have so argued, that a set-off is not allowed when the two debts sought to be set off are not "mutual debts". The subject of mutuality will be taken up in detail in a later argument.

For the purpose of this argument appellants wish to state generally its reasons for claiming its right of set-off.

As the trustee has stated in an earlier brief (R. 148), "the crux and the determining factor of this review is whether or not McKee, in its individual capacity, has, as it maintains, a right of set-off." If the answer is in the affirmative, then appellants should prevail. If, on the other hand, the answer is in the negative, then the trustee should prevail.

The trustee has attempted to confuse this primary issue by bringing Tucson House Construction Company into the lawsuit (R. 40), and by stating that there were never mutual debts between Fike and Tucson House Construction Company (See Trustee's Legal Position No. 1, R. 47). The issue is not, as the trustee argues, whether Tucson House Construction Company was ever owed anything by Fike, but rather, whether McKee, either individually or as a co-adventurer, ever owed anything to Fike. Tucson House Construction Company is not the party attempting to effect a set-off in this case. McKee, either individually or as a co-adventurer in Tucson House, is the party attempting to effect a set-off. The real question to be decided in this appeal is whether McKee had a right to set-off the monies it owed, jointly and severally, to Fike on the Tucson House project in payment of Fike's obligation to McKee on the Lincoln Hospital project.

2. Fike became obligated to McKee as a result of its default on the Lincoln Hospital project.

In order for appellants to prove their right of set-off, one of the things they must show is that Fike owed a debt to McKee.

Although the facts clearly establish that Fike became obligated to McKee as a result of its default on the Lincoln Hospital project, the Referee failed to specifically include this in his Findings of Fact or Conclusions of Law.

The Referee did, however, state in his Finding of Fact numbered 15 that the Lincoln Hospital project "did not go into default until after bankruptcy". Respondents' Exhibit No. 9 clearly shows that as of November 16, 1964, Fike was defaulted by McKee on its subcontract. It wasn't until the following day, November 17, 1964, that Fike filed its voluntary petition in bankruptcy.

If the above Finding is based upon Trustee's Exhibit 7, then the trustee and the Referee have completely ignored the law on this subject. The evidence is clear that McKee had knowledge that Fike was in fact in default on the Lincoln Hospital project prior to Fike's bankruptcy, and the law is clear that a default does not have to be formally declared. *Massachusetts Bonding and Insurance Company v. State of New York* (2d Cir. 1958) 259 F.2d 33.

By the terms of the contract dated May 31, 1963, between McKee and John C. Lincoln Hospital, Incorporated (Respondents' Exhibit 7), McKee became obligated to pay all claims arising out of the construction of this project, including unpaid materialmen's claims. In order to insure this, John C. Lincoln Hospital, Incorporated, required the execution of a bond (Respondents' Exhibit 7), by which McKee, as principal, and General Insurance Company of America, as surety, became jointly and severally liable for unpaid claims for labor and materials, including those claims arising out of materials furnished to Fike under its subcontract. By virtue of this bond, Fike's suppliers would be able to sue McKee directly, without having to join the bankrupt Fike.

Although the trustee has argued (R. 149) that no obligation existed on the part of McKee to pay Fike's suppliers on the Lincoln

Hospital project for the reason that there was no contractural relationship between McKee and these suppliers, the above two documents alone (Respondents' Exhibit 7) would be sufficient to demonstrate McKee's obligation to pay Fike's suppliers on the Lincoln Hospital project.

In addition, McKee entered into a subcontract with Fike (Respondents' Exhibit 8), wherein Fike agreed to protect, indemnify and hold McKee harmless from any and all liability, damages, claims, and expenses resulting directly or indirectly from the performance of the subcontract. The evidence is clear, therefore, that the $50,745.12 which McKee has paid for labor and materials supplied to Fike in connection with the Lincoln Hospital project (Respondents' Exhibit 10), represented obligations for which McKee was directly liable, and for which Fike was liable over to McKee. The fact that McKee sought to protect itself by requiring Fike to obtain a bond (Trustee's Exhibit 5) in connection with the Lincoln Hospital project in no way diminishes the fact that an obligation existed on the part of McKee for the payment of Fike's suppliers.

There is an additional reason why the fact that Reliance Insurance Company is Fike's surety on the Lincoln Hospital project does not detract from the fact that McKee has an obligation on that job, and this relates to the laws of the State of Arizona. The trustee has attempted to confuse the subrogation rights of Reliance and the fact that Reliance was contractually responsible to Fike's suppliers on the Lincoln Hospital project with the obligations imposed upon McKee. Bonds are not one-way streets. Before the surety becomes obligated, it must first be shown that the obligee, in this case McKee (Trustee's Exhibit 5), has performed all of its obligations.

Arizona Revised Statutes Sec. 12-1641 reads as follows:

§ 12-1641. Action by creditor; failure to bring action and effect

"Any person bound as surety upon a contract for payment of money or performance of an act, when the right of action

has accrued, may require, by notice in writing, the creditor or obligee forthwith to bring an action upon the contract. If the creditor or obligee, not being under legal disability, fails to bring the action within sixty days after receiving the notice, and prosecute it to judgment and execution, the surety giving the notice shall be discharged from all liability thereon."

By the above statute, Arizona, along with 18 other states, has adopted the doctrine of *Pain v. Packard* (N.Y. 1816) 13 *Johns* 174,[6] which allows the surety to first require the obligee to seek his recovery from the principal. In this case Reliance requested McKee (T. II 35-36) to use the monies owed to Fike on the Tucson House project, by way of set-off, to pay Fike's bills on the Lincoln Hospital project.

---

[6]There is an excellent discussion of the doctrine of *Pain vs. Packard* in *Simpson on Suretyship* on pages 178-179 which reads as follows:

"The rule that mere quiescence by the creditor will not affect the surety's continued liability has been limited in three states by judicial decision, to the effect that a surety has the right to compel the creditor, by notice, to proceed against the principal debtor, at peril of discharging the surety to the extent that the latter can show damage by non-compliance. In the leading case applying this view, from which the doctrine derives its name, the defendant was known to be a surety and requested the creditor to sue the principal at maturity. It was held that his plea that the principal was solvent when the creditor was requested to sue, and could have been compelled to pay, but that he later became insolvent and absconded, so that the plaintiff could not obtain payment, stated a good defense. The court said: 'The fact of Packard having been security only, is fairly to be presumed to have been known to the plaintiff. He was, in law and in equity, therefore, bound to use due diligence against the principal, in order to exonerate the surety.' This view, however, appears to be indefensible, because one of the creditor's purposes in insisting upon the surety's undertaking is to avoid the burden and delay of enforced collection; and it has accordingly been rejected by a large majority of the courts. There is, of course, nothing in the Pain v. Packard doctrine which prevents the creditor from taking a judgment against the surety as well as the principal debtor. The surety is liable at maturity; the guarantor is liable immediately on default by the debtor. It is obviously unfair to require the creditor to stay his hand against a collateral promisor a moment after the time contemplated for payment by him, and there is no discernable reason for holding that the surety should not pay. Eighteen states have adopted the Pain v. Packard doctrine by statute. Under such statutes the creditor's failure to sue is sometimes held to discharge the surety, even though such failure causes him no loss."

Therefore Reliance never became obligated to "pay all unpaid charges", as contended by the trustee. The trustee's entire argument relating to Reliance's right of subrogation under Sec. 57(i) (R. 149) of the Bankruptcy Act is a complete smoke screen for the reason that Reliance's right of subrogation has not come into existence. Reliance did not make the payments in question to Fike's suppliers on the Lincoln Hospital project. McKee did, by effecting its right of set-off. Furthermore, Reliance is not a party to this lawsuit, and it is not attempting to effect the set-off in this case.

The trustee has argued that no inequity would result to appellants if the trustee is allowed to prevail, because of McKee's indemnity agreement from Reliance (Trustee's Exhibit 10). The fact that McKee has indemnification does not change the legal principles involved here. For if it does, then inequities are going to result to Reliance. Reliance had a legal right under A.R.S. Sec. 12-1641, which adopts the doctrine of *Pain v. Packard, supra,* to compel McKee to proceed against Fike by exercising its right of set-off. To the extent McKee failed to do this, Reliance would have been discharged and McKee would have suffered the loss. The fact that Reliance was willing to give McKee an indemnity against loss for effecting the set-off (T. II 35-37) should not take away the legal rights of both McKee and Reliance. Such a result would be in itself inequitable.

3. A joint venture or partnership was not formed in connection with Tucson House.

In his Finding of Fact numbered 3 the Referee states that McKee, Robbins and Schiff "formed a joint venture". This statement is a conclusion of law which must be based upon facts. The Referee gave no findings of facts which would support such a conclusion. Likewise, in Finding of Fact numbered 5 the Referee states that "it is admitted, and the Court so finds that McKee was acting for and on behalf of the joint venture". McKee has never admitted that a joint venture existed, and its main contention

is that there is no partnership or joint venture involved under our fact situation.

Arizona Revised Statutes Sec. 29-206(A) defines a partnership as "an association of two or more persons to carry on as co-partners a business for profit." Therefore, the essential elements of a partnership are: (1) an association; (2) two or more persons; (3) to carry on a business; (4) the persons must be *co-owners* of the business; and (5) the purpose of the business must be for profit.

Thus, it can be seen that there must be an intention to carry on a business, and that the persons involved must be co-owners of the business. The Trustee has attempted to show that the "joint venture agreement" (Trustee's Exhibit 2) dated July 2, 1962 between Robert E. McKee Geenral Contractor, Inc. and Bernard W. Robbins and Raymond S. Schiff, constituted a partnership limited to the single transaction of constructing Tucson House. While it is true that there are many Arizona cases which state that a joint venture differs from a partnership principally in that it is limited to a single transaction (see *Smith v. Phlegar* (1951) 73 Ariz. 11, 236 P.2d 749; *Ruby v. United States Co. S.A.* (1941) 56 Ariz. 535, 109 P.2d 845), the usual tests for determining the existence of a partnership or joint venture include: (1) a contract; (2) a common purpose; (3) community of interest (co-ownership) in the business conducted; (4) an equal right of control; and (5) an agreement to share profits and losses. *West v. Soto* (1959) 85 Ariz. 255, 336 P.2d 153.

It is McKee's contention that the intention of the parties, as set out in the "joint venture agreement" mentioned above, is spelled out to such a degree that there can be no question that a partnership was *not* formed. A review of the agreement will show that almost all of the elements (some of which are absolutely necessary to a partnership) are missing. Paragraph 1 of the "joint venture agreement" recites the fact that the parties have entered into this agreement for the sole purpose of entering into the

construction contract for the Tucson House project. This was a device whereby Robbins and Schiff obtained an identity of interest with the contractor while retaining their beneficial interest in the land, legal title to the land being held by Tucson Title Insurance Company, as Trustee. McKee never obtained any ownership interest in the project. McKee was, however, the general contractor on the Tucson House project, and, as shown in Paragraph 5 of the agreement, was in exclusive charge of every phase of the construction. Thus, there was no equal right of control.

In Paragraph 8 of the agreement, McKee agreed to indemnify Robbins and Schiff from any losses which they might suffer as a result of the "joint venture," including those arising as a result of the activities of any subcontractor (T. I 57-64). Thus, no sharing of losses was intended, and all such losses were McKee's.

Although the agreement was labeled a "Joint Venture Agreement", in reality it was not a joint venture in the partnership sense, but an arrangement for the purpose of helping out the owners (Robbins and Schiff) in obtaining financing of the project (T. I 54-57). The three parties to the agreement were not partners for the reason that their venture was not a business under the better rule that a business, as such, contemplates the doing of a series of acts toward a specific end, not the mere performance of a single transaction or type of activity. The usual distinction between a partnership and a joint venture is this — each partner is a general agent of his partners, but each joint adventurer is not an agent of his co-joint adventurers. *Nolan v. J. & M. Doyle Co.* (1940) 338 Pa. 398, 13 A.2d 59. In Paragraph I of the agreement, the parties specifically stated that "the joint venture shall not constitute a general partnership between the parties and shall not authorize any party to act as the agent of any other party except as specifically authorized herein." It is clear that the intention of the parties throughout the agreement was to enter into a contract and not a business. Even if it could be contended that the joint venture arrangement amounted to

a business, the essential element of co-ownership, which would make the arrangement a partnership, is lacking.

The recitals in the agreement clearly state that Robbins and Schiff own all the beneficial interest in the land, and nowhere does the agreement state that McKee had or obtained any ownership interest in the project, and in fact, it had none. Therefore, the vital element of a community of interest or co-ownership is lacking. That this element is necessary has been spelled out in a number of cases including *West v. Soto,* supra.

The fact that Paragraph 9 of the agreement states that McKee shall receive payments as its share in the joint venture does not constitute a prima facie case of partnership since, as stated in Arizona Revised Statutes Sec. 29-207,[7] "no such inference shall be drawn if such profits were received in payment: (a) As a debt by installments or otherwise". The "sharing" in this case was merely a convenient method for the beneficial owners to pay their

---

[7] A.R.S. Sec. 29-207 reads as follows:

§29-207. Rules for determining the existence of a partnership

"In determining whether a partnership exists, these rules shall apply:

1. Except as provided by § 29-216 persons who are not partners as to each other are not partners as to third persons.

2. Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.

3. The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.

4. The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:

(a) As a debt by installments or otherwise.

(b) As wages of an employee or rent to a landlord.

(c) As an annuity to a widow or representative of a deceased partner.

(d) As interest on a loan, though the amount of payment vary with the profits of the business.

(e) As the consideration for the sale of a good will of a business or other property by installments or otherwise."

debt or the costs of construction to McKee, and McKee received such proceeds as part payment of such debt, as shown in Paragraph 9(a) of the agreement. This clear showing of the intent of the parties overcomes any prima facie case of partnership made out by the "sharing". There was, therefore, no agreement to share profits as such, because what McKee was to receive was guaranteed and determined in advance, and *there can be no partnership without an agreement to share the profits. Estrella v. Suarez* (1943) 60 Ariz. 187, 134 P.2d 167.

In short, it does not appear that there was ever an intention on the part of McKee on the one hand and Robbins and Schiff on the other to become partners. The general rule is that persons who are not partners as to each other cannot be partners as to third persons. Since the "joint venture agreement" does not provide: (1) for a share of profits or losses; (2) for equal right of control; or (3) for a community of interest, it cannot be seriously contended that it was the intention of the parties that a partnership be formed.

This point is further emphasized in the Referee's Finding of Fact numbered 14, that the "joint venture" transferred the sum of $50,745.12 to McKee on February 19, 1965 (Trustee's Exhibit 15)[8] *long after* the bankruptcy trustee made a demand upon the "joint venture" for the funds and instructed it not to disburse the retention proceeds. There is no evidence in the record to support this finding. The demand leters the Referee is apparently talking about are Trustee's Exhibit 9, written January 22, 1965, and Trustee's Exhibit 16, written February 11, 1965, by the attorney for the trustee, both letters being directed to *Robert E. McKee General Contractor, Inc.* Even the trustee recognized that the contractor on the Tucson House project was McKee, and that the obvious person to send such demand letters to would be McKee.

---

[8]Note that the checks effecting the set-off or transfer are dated February 15, 1965.

4. The two debts sought to be set off are mutual debts for the reason that McKee owes its Tucson House debt to Fike, whether such debt be considered as an individual debt or one which is owed jointly and severally.

Section 68 of the Bankruptcy Act allows set-offs against a bankrupt by one of its debtors on the condition that the debts are mutual. It has been said that in order for mutuality to exist, each party must own his claim in his own right severally, and the right to collect it in his own name against the debtor, in his own right and severally.[9] The trustee's major contention, and the conclusion reached by the Referee, is that the debts are not "mutual" within the purview of the Bankruptcy Act. This conclusion is erroneous. The only way that the Referee could have reached this conclusion was on the basis of certain cases presented by the trustee which have no applicability to the facts of this case.

The trustee basically relied on a quotation in Collier on Bankruptcy that a joint debt cannot be set-off against a separate debt, and vice-versa.[10] The authority for this statement is a New York case, *In re Shults* (D.C.N.Y. 1904) 132 F. 573.

The *Shults* case involved a transfer situation in which certain depositors assigned their claims against the bank, which was in reality a bank partnership subsequently adjudicated a bankrupt, to a firm of which one of the depositors was a member, and which was a debtor of the bank, for the purpose of enabling such claims to be used as a set-off against the indebtedness. This was clearly a preference situation, having no resemblance to the facts of our case.

The Court, in the *Shults* case, stated "*The rule in the State of New York* seems to be that a joint debt cannot be set off or operate as a counterclaim against a separate debt, or, conversely, a separate debt against a joint debt." Because of this rule, the Court held in the *Shults* case that a solvent partnership which is indebted to a

---

[9]4 *Collier, Bankruptcy,* 14th ed., § 68.04, pp 735-736.

---

[10]4 *Collier, Bankruptcy,* 14th ed., § 68.04, p 736.

bankrupt cannot set off against such indebtedness a claim due from the bankrupt estate to one of the partners. The State of New York follows the common law rule that contractual obligations of partners are joint only, and not joint and several. Thus the holding in the *Shults* case is that joint debts and several debts are not mutual, and can not be set-off one against the other. The rule in Arizona differs from the common law rule, however, and therefore the rule in *In re Shults* does not apply to this case.

Airzona has by statute made partners' contractual obligations both joint and several. Such a result is clearly intended by omitting the word "jointly" in §29-215 Arizona Revised Statutes, which reads "All partners are liable jointly and severally for everything chargeable to the partnership under §§29-213 and 29-214, and [jointly omitted here] for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract."[11]

Therefore, if, as the trustee argues, McKee entered into a partnership agreement with the beneficial owners, then, by virtue of the above statute, McKee remains severally liable for any debt owed the bankrupt, and the requisite mutuality is present. McKee contends that its right to set-off its Tucson House debt against Fike's obligation arising out of the Lincoln Hospital project is valid and bona-fide. This is not a case of a joint debt trying to be set-off against a separate debt, or vice versa, but of a *separate debt* being *set-off against a separate debt.* Mutuality exists, since each party owns his claim in his own right, severally, with the right to collect it in his own name against the debtor, in his own right and severally. The test of mutuality, therefore, is: Can Fike, under Arizona law, sue McKee individually to collect the monies alleged to be due from the Tucson House project? Since McKee's liability on that project is *several* as well as joint under the Arizona Partnership Act, the answer is yes, and therefore mutuality exists.

---

[11]See Commissioners Notes, Uniform Partnership Act, 7 Uniform Laws Annotated, Sec. 15.

There are many cases which support McKee's contentions, including annotations in 5 *A.L.R.* 1541 and 55 *A.L.R.* 566, regarding the right to set-off a claim of an individual partner against a claim against the partnership, where the partnership liability is joint and several. In *Columbia Taxicab Co. v. Mercurio* (1921) 208 Mo.App. 492, 236 S.W. 1096, it appeared that a partnership was sued for damages resulting to the plaintiff by reason of a collision between the plaintiff's automobile and a truck owned by the partnership and operated by one of the partners. The Court held that, a partnership debt being joint and several, each member may be sued separately and made to pay the whole of it, and therefore it follows that the separate demands of each member of a partnership may be set-off against their joint (and several) obligation.

In *Boeger & Buchanan v. Hagen* (1927) 204 Ia. 435, 215 N.W. 597, it was held that in an action by a receiver of an insolvent bank on a partnership note, the personal deposit account of one of the partners may be allowed properly as a set-off against the bank's claim against the firm on the partnership note, in view of a statute which makes each member of a partnership primarily liable for the partnership debts. The Court followed the rule suggested by Justice Holmes in a United States Supreme Court case (*Francis v. McNeal* (1913) 228 U.S. 695, 33 S.Ct. 701, 57 L.Ed. 1029) that a partnership debt is in reality the individual debt of each of the individual members of the partnership, and their liability thereon is a primary liability and not a secondary one.

Another case in point is *Bryant Bros. v. Wilson* (1934) 253 Ky. 578, 69 S.W.2d 1020. In that case the lower court had prevented one partner from relying upon his individual claim against the plaintiff as a set-off against the latter's action against the partnership for the reason that the necessary mutuality was wanting. The lower court stated that at that date the individual partner was only jointly liable with his other partners for the partnership

obligation, and was not separately and individually liable to the owner of the obligation for the entire debt. The Supreme Court of Kentucky reversed the lower court and allowed the set-off, saying: "Statutes in this and other states have eliminated that basis for that theory, since a joint contractor is severally and individually liable for the entire joint obligation. Hence it is now the law in this state, and in practically, if not in all of the others, that one of two or more joint obligors may set off plaintiff's joint obligation by the amount of an individual claim due him or them from plaintiff."

The trustee's attorney, during the course of oral argument, responded to McKee's joint and several liability theory by saying, "Mr. Haug gave you umpteen cases on offset . . . there isn't a single bankruptcy case in there, nothing with bankruptcy, just a lot of general stuff, . . ." (T. II 55). The trustee's attorney then cited the one case he found involving a bankruptcy situation, *Poncet Davis Co. v. Roberts* (5th Cir. 1943) 138 F.2d 538, in which there is no discussion by the Court on the question of mutuality. The Court denied the set-off in that case because it was being asserted in a consolidated claim, and the law did not authorize the filing of such a claim. (T. II 43-45). It should also be pointed out that the person attempting the set-off in that case was the alter ego of the *bankrupt* corporation, and the facts are so blatantly dissimilar that under no circumstances could it be considered as controlling in our case.

The trustee argues that "a partnership debt is first and foremost the responsibility of the partnership" (R. 150). The trustee then presents the case of *Springer v. Bank of Douglas* (1957) 82 Ariz. 329, 313 P.2d 399 for the proposition that "the liability of a co-partner becomes his several obligation only when the partnership property is inadequate to pay the partnership debts, or when there is no effective remedy without resort to his individual property."

The basic facts of the *Springer* case were that one co-partner

executed a promissory note on behalf of the partnership. The Court held that if such note was secured by a mortgage on partnership assets, then the maker would be entitled to have the assets covered thereby applied toward the satisfaction of the partnership debt, before enforcing the judgment against the partner personally. There is no evidence in our case which suggests the possibility of a mortgage existing on the "joint venture" assets, and the limited holding of the *Springer* case does not apply to our fact situation. Under no stretch of the imagination could the *Springer* case be interpreted as denying McKee its right of set-off under our fact situation, even if we take the trustee's case at its best and assume that a "joint venture" had been formed. For in that case McKee's liability would be joint and several, and the assets of the "joint venture" would not have to be first exhausted before McKee would be responsible severally.

Appellants urge that the Court consider the case of *In re Sherman Plastering Co.* (2d Cir. 1965) 346 F.2d 492, which decision should lay to rest trustee's argument that a joint and several debt can not be set-off against a separate debt, and vice-versa. The *Sherman* case involves the Bankruptcy Act and holds that joint and several debts (e.g. Arizona partnership debts) are mutual to several debts.

In the *Sherman* case the court held that a surety's successor (Hanover), which was under a joint and several obligation to a debtor-in-possession (Sherman) on a claim on a performance bond, could set-off a several claim against the debtor-in-possession arising out of a prior transaction in which it was surety for the debtor-in-possession.

On March 15, 1963, Sherman Plastering Corp. (Sherman) filed a petition for a Chapter XI arrangement, and was thereafter permitted to operate its business as a debtor-in-possission. Several years prior to filing its petition, Sherman was engaged as a subcontractor by Joseph Rugo, a prime contractor, in the construction of an office building for the State of Maine. Sherman had

faithfully performed its duties and, when Rugo defaulted in payment, Sherman turned to the bond furnished by Rugo. This bond was executed in 1956 by three corporate sureties, Massachusetts Bonding & Insurance Co. (Mass. Bonding), United States Fidelity & Guaranty Co. (Fidelity), and American Automobile Insurance Co. (American). The bond bound the sureties " 'jointly and severally' as well as 'severally' "; and it obliged Mass. Bonding to pay 50 per cent of the penal amount and the other two sureties to pay 25 per cent each. In 1957 Sherman commenced an action on the bond in the name of the State Treasurer; and on February 24, 1964, a judgment of $39,943.15 plus interest was entered in its favor, which was affirmed on appeal on January 11, 1965 save for the method of computing the interest. The court then stated:

> "The sureties were explicitly held jointly liable (a point much stressed by appellant although we can perceive no difference here relevant between a joint and several liability). Sherman could collect up to the whole judgment from any one or more of the obligors; and to the extent that this exceeded any obligor's pro rata share, that obligor would have to seek reimbursement from the others. 4 Corbin, Contracts, § 928 (1951)." (346 F.2d at p. 493).

The sureties consented to the jurisdiction of the bankruptcy court and sought to satisfy their obligations arising from the Maine judgment. Fidelity and American tendered to the bankrupt-Sherman their pro rata shares of the judgment, and Hanover Insurance Co. (Hanover), which had succeeded to Mass. Bonding's rights during the pendency of the Maine action, sought to discharge its pro rata share by offsetting it against an unrelated indemnification claim owed from the debtor when it filed its proof of that claim on February 24, 1964. This claim arose from Sherman's contractual duty to reimburse Hanover for payments made under another performance bond issued in 1960, by which Hanover acted as surety for Sherman in another construction job.

In the words of the court,

> "Sherman resisted, and refused the tenders for obvious rea-

sons. Its strategy was to collect the full amount of the Maine judgment from American and Fidelity, with the hope of destroying Hanover's set-off, thereby enabling it to pay off Hanover's claim at the scaled down rate fixed in the Chapter XI arrangement and yet to satisfy its claim under the Maine judgment in full. It sought to justify this position by invoking the maxim that a joint debt (the debt owed by Hanover) cannot be set off by a single debt (the debt owned by Hanover), and by insisting that this maxim was embodied in the mutuality-of-debts requirement of section 68 of Bankruptcy Act." (346 F.2d at p. 493).

The Referee in Bankruptcy initially enjoined Sherman from executing and enforcing the Maine judgment; but he vacated this injunction after reaching the merits of Hanover's petition and deciding to disallow the set-off for want of the requisite mutuality. On a petition for review, however, the District Court reversed the Referee and allowed the set-off.

The Circuit Court affirmed the District Court's order modifying the Referee's disposition by saying:

> "No legitimate interest would be served by disallowing this set-off, and in fact disallowing the set-off would frustrate the manifest equitable purposes of section 68. It would put Hanover in the inequitable position of having to pay its debt to Sherman in full while receiving only partial satisfaction of its claim against Sherman. Neither the rehabilitative purposes of a Chapter XI arrangement nor section 68's requirement that the debts be mutual dictates such a result. The debts are owed and owned by the same party, acting in the same capacity. The jointness of the debt owed by Hanover affords Sherman the alternative of collecting the whole amount from the other joint obligors. However, the availability of this alternative, conceived of as a means of protecting the obligee from certain contingencies, none of which materialized in this case, such as the insolvency or lack of amenability to suit of the other joint obligors, does not mean that Hanover does not owe its agreed upon share of the joint debt, or that it owes it in a different capacity than it owns its debt against Sherman. There was equity in preventing Sherman from pursuing the course it sought to follow." (346 F.2d at pp. 493-494).

Thus in diagram form the Sherman case appears like this:

(owes)
Sherman ⟶ Hanover
(owes) O.K. to offset
Bonding Cos. (Hanover) ⟶ Sherman
Joint & (Several)

A diagram of our case would look like this if a joint venture was actually formed:

(owes)
Fike ⟶ McKee (Lincoln Hospital)
(owes)
Joint Venture (McKee) ⟶ Fike (Tucson House)
Joint & (Several)

The similarity between the cases is immediately apparent, and it should be noted in both these instances that the debt is *owned* by the non-bankrupt *individual,* and *owed* jointly and *severally* by the party effecting the set-off.

The Court in the *Sherman* case went on to say:

> "There is . . . no inequity in allowing the set-off in the instant case. Neither Hanover's joint obligors nor its creditors could be prejudiced by the set-off. Nor would the joint obligors be receiving an unfair benefit, for if the set-off is allowed they would be paying no less than their pro rata share of the joint liability; and there is nothing unfair about saving them the expense, or foregoing the risk that would be involved in seeking reimbursement from Hanover if they were obliged to pay more than their pro rata share of the joint liability. Moreover, Sherman would have the 'reciprocal right to do the same thing,' that is, if Hanover rather than Sherman were bankrupt Sherman could apply Hanover's pro rata share of liability under the Maine judgment to discharge its obligation to Hanover." (346 F.2d at pp. 494-495).

In our case McKee has fully indemnified Robbins and Schiff, and thus our joint obligors likewise would not be receiving an unfair benefit if the set-off is allowed.

No legitimate interest would be served in disallowing this

set-off, and, in fact, disallowing the set-off would violate the obvious equitable purposes of Sections 68 of the Bankruptcy Act. It would put McKee in the inequitable position of eventually having to pay its debt to Fike in full, while receiving only a partial satisfaction of its claim against Fike.

The Court in the *Sherman* case, in affirming the District Court order reversing the Referee in Bankruptcy, concluded as follows:

> "The venerable maxim that a joint debt cannot be set off against a separate debt, and vice versa, see 3 Story, Equity Jurisprudence, §1874 (14th ed. 1918), like all maxims tested by experience, has its exceptions, and this is one of them." (346 F.2d at pp. 496-497).

5. The proceeds obtained by McKee in connection with Tucson House were not wrongfully obtained, nor were they "trust proceeds".

The trustee first advanced his "trust theory" argument to demonstrate the summary jurisdiction of the Bankruptcy Court. The Referee in Conclusion of Law numbered 1 (a) decided that he had jurisdiction because the Tucson House debt was a "trust fund," and because at the date of bankruptcy the "fund" was in the constructive possession of the Court. The Referee overlooked the fact that Fike's contract was with appellants, who had no obligation to pay Fike out of the monies it received from the "Owner". Appellants could choose any fund out of which to pay Fike's retention money (T. I 104), and for this reason alone there was never a trust in favor of Fike on any particular fund of money.

Moreover, Fike's right to be paid was not absolute, but only conditional on its proper performance, not only of the Tucson House contract, but also any contracts which it might have had with appellants. The trustee can stand in no better position with respect to this obligation than Fike. This makes even better logic when we conceive of Fike's property interest in the "fund", assuming such a "fund" ever existed, as a bundle of rights in the Hohfeldian sense. All Fike is able to give to the trustee is a few strings to the "fund", not the "fund" itself. These strings were

cut when Fike failed to perform all the obligations it owed to appellants, and the trustee's right to the "fund" ceased to exist.

The only possible way Fike might have obtained an interest in the "fund" while it was in the hands of the "Owner" was by perfecting a valid Notice and Claim of Lien under the Arizona statutes. Under such circumstances the owner is given the right to withhold payment from the contractor, and, under certain conditions, is given the right to pay to the subcontractor the amount of his lien. We believe this was the basis for the Referee's holding in his Conclusion of Law numbered 1(b). This point will be discussed in the following argument.

The trustee further relied on his "trust theory" for the proposition that McKee was not entitled to a set-off. Appellants agree with the trustee that where the liability of the one claiming a set-off arises from a fiduciary duty or is in the nature of a trust, the requisite mutuality of debts does not exist, and such person may not set-off a debt owing from the bankrupt against such liability. However, never was it shown by the trustee that McKee owed any fiduciary duty to Fike or that a trust existed.

The only trust involved in our fact situation is the trust under which Tucson Title Insurance Company held legal title to the property in question, as Trustee. The joint venture agreement (Trustee's Exhibit 2) or contract arrangement between McKee, as contractor, and Robbins and Schiff, as beneficial owners of the property, provides, as previously pointed out, that McKee shall be in charge of the construction, make all subcontracts, *collect all monies* that may accrue under the construction contract and be responsible for the work to the end of final completion. In addition, McKee is responsible for all monies paid out, as defined under Paragraph 10 of the agreement under the term "actual costs of construction". There is nothing in the agreement which provides for Robbins and Schiff to collect any monies.

Therefore, it cannot be logically contended that the proceeds the trustee is seeking were obtained by McKee "illegally". McKee,

by virtue of its agreement with the beneficial owners, was responsible to collect the monies and make all payments, including the 10% retention proceeds due Fike upon completion and acceptance of Fike's work by the owners. McKee, therefore, obtained these proceeds legally and in accordance with its contract with the beneficial owners.

6. The lien urged by the trustee is completely invalid for the reason that a copy of the Notice and Claim of Lien was never served upon the owner as required by the laws of the State of Arizona.

In Finding of Fact numbered 11, a statement is made that the owner was not prejudiced by the failure of Fike to serve a copy of the Notice and Claim of Lien upon the owner. Whether there was or was not prejudice is wholly immaterial to this case. The statement, which is a conclusion of law, was made for the purpose of attempting to establish the trustee's so called "trust theory", which has been previously discussed.

Appellants have always maintained that the trustee's claimed lien was invalid. The laws of the State of Arizona[12] require that

---

[12] A.R.S. Sec. 33-993 which reads as follows:

§ 33-993. Procedure to perfect lien; notice and claim of lien; service; filing

"In order to impress and secure the lien provided for in this article, every original contractor, within ninety days, and every other person claiming the benefits of this article, within sixty days after the completion of a building, structure or improvement, or any alteration or repair thereof, shall make duplicate copies of a notice and claim of lien and file one copy with the county recorder of the county in which the property or some part thereof is located, and within a reasonable time thereafter serve the remaining copy upon the owner of the building, structure or improvement, if he can be found within the county. The notice and claim of lien shall be made under oath by the claimant or some one with knowledge of the facts, and shall contain:

1. A description of the lands and improvements to be charged with a lien, sufficient for identification.

2. The name of the owner or reputed owner of the property concerned, if known, and the name of the person by whom the lienor was employed or to whom he furnished materials.

(Footnote continued)

a copy of the Notice and Claim of Lien be served upon the owner within a reasonable time after the instrument is filed. The trustee has admitted (T.I 123) that no copy of the Notice and Claim of Lien was ever served upon Tucson Title or McKee. The trustee likewise has never proved that a copy was served on either Robbins or Schiff, the beneficial owners.

A.R.S. Sec. 33-994 provides that the owner, upon being *served* with a Notice and Claim of Lien, *may* retain, out of the amount due or to become due the original contractor, the value of the labor and material shown by the lien. The owner is then required to furnish the contractor with a copy of the lien, and if the contractor does not object to the lien within 10 days, the owner can pay the lien claimant. The purpose of this statute is to protect the owner against the delinquencies of the contractor, and is not mandatory, but merely permissive on the part of the owner. Perhaps if Fike had followed this procedure and perfected a valid lien, there might have been merit to the trustee's argument. The facts, however, do not support the trustee. While it is true that Fike filed the lien, the Referee found as a fact that the lien was not served upon the "Owner".[13]

The lien must be both filed and served if there is to be substantial compliance with the lien law and a validly perfected lien. *Leeson v. Bartol* (1940) 55 Ariz. 160, 99 P.2d 485. Since the lien was not valid, there was never a trust in favor of Fike on any particular fund of money, and there is absolutely no evidence in the record which will support a "trust theory" arising out of Fike's filing a lien. For the Referee to reach the conclusion that the appellants didn't have a legal right, because of the lien, to

---

(Footnote continued)

3. A statement of the terms, time given and conditions of the contract, if it is oral, or a copy of the contract, if written.

4. A statement of lienor's demand, after deducting just credits and offsets."

---

[13]See Referee's Finding of Fact numbered 11.

receive from the "Owner"[14] the money that the "Owner" was obligated by contract to pay the appellants, is completely erroneous.

The Trustee has presented the case of *Green v. H. E. Butt Foundation* (5th Cir. 1954) 217 F.2d 553, for the proposition "that once a lien claimant files a claim of lien, that the amounts claimed by virtue of that lien become impressed with a trust" (T.II 13-14). The *Green* case obviously deals with a situation where the lien has been properly perfected, while the trustee in our case has never even argued that Fike's lien was properly perfected. In *Leeson v. Bartol, supra,* the lien claim was served within a reasonable time as provided by the statute; but that case pointed out that there must be substantial compliance with the lien law, and certainly does not stand for the proposition that failing to serve a copy of the lien claim on the owner allows for a finding of substantial compliance.

7. McKee had a legal right to retain the retention proceeds on Tucson House for the life of Fike's warranty.

On August 6, 1962, Fike and appellants entered into a subcontract (Trustee's Exhibit 3), in which Fike agreed to furnish labor and materials for the Tucson House project. In Paragraph 27 of this contract Fike agreed to guarantee all work performed in the course of the Tucson House project against defective materials and/or workmanship for a period of one year from the date of acceptance by the owner of the *completed* contract. In Paragraph 19 of this contract Fike further agreed that the contract could be canceled at appellants' option if Fike failed to properly perform any term, covenant, or condition of the contract,

---

[14] The trustee has had difficulty in distinguishing between the legal owner of Tucson House, Tucson Title Insurance Company as Trustee, and the beneficial owners, Robbins and Schiff. Since neither the legal nor beneficial owners were served with a copy of Fike's Notice and Claim of Lien, appellants contend that McKee was rightfully entitled to final payment, whether it be considered to come from the beneficial owners or through the medium of the trustee as legal owner.

and that all losses should be deducted from the contract price therein stated.

Thus, by the very terms of the subcontract, McKee had the right to retain the retention proceeds in the exercise of its option to cancel the contract, and it could therefore deduct any losses or expenses incurred by Fike's breach of the contract, and also exercise any legitimate right of set-off to which it was entitled.

In addition, appellants claim that the act of bankruptcy was an immediate anticipatory breach of contract (T.II 50-52), as has been held by the Supreme Court of the United States, and it was therefore not necessary for appellants to tender the retention proceeds to the bankrupt. *Central Trust Co. v. Chicago Auditorium Asso.* (1916) 240 U.S. 581, 36 S.Ct. 412, 60 L.ed. 811; *In re Robertson* (D.C. Ark. 1941) 41 F.Supp. 665, 668; *United States v. Brunner* (10th Cir. 1960) 282 F.2d 535, 538; *In re Hot Springs Broadcasting Co.* (D.C. Ark. 1962) 210 F.Supp. 533, 542. Appellants agree that if Fike had not gone into bankruptcy and had been able to perform its warranty obligations, or if the trustee had agreed to assume these obligations within a reasonable time,[15] which he never did, then appellants might have been obligated to turn money over to Fike had no right of set-off existed.

In our situation, however, Fike placed itself beyond the position of being able to perform its warranty obligations, and therefore no trust could have been placed on the retention funds which would have required appellants to turn the money over to the trustee.

The trustee has argued that Fike had earned the retention proceeds here in issue long before its bankruptcy (R. 63). Appellants disagree with this argument. Webster's Dictionary defines "earn" as "to become entitled to", and certainly it cannot be successfully argued that Fike was entitled to the retention

[15] Bankruptcy Act, Sec. 70(b)

proceeds, in view of its warranty obligations and McKee's right of set-off. For the trustee to argue that Fike's ultimate bankruptcy was not a breach of the subcontract, insofar as Fike's right to the retention proceeds was concerned, is contrary to the law. Since Fike was unable to perform its warranty obligations, and the trustee unwilling to assume them, appellants never became obligated to turn over the retention proceeds until the warranty period expired, notwithstanding McKee's right to set-off the majority of the retention monies.

In Finding of Fact numbered 16 it is stated that the "joint venture" never made a demand upon the trustee to perform the warranty portion of Fike's subcontract on the Tucson House project. This statement of fact is completely misleading for it assumes that there is a duty incumbent upon a contractor to demand that the trustee perform an executory contract. Clearly, under section 70(b) of the Bankruptcy Act the trustee has 60 days within which to assume or reject any executory contract, and any such contract not assumed or rejected within 60 days after the bankrupt's adjudication, whether or not a trustee has been appointed or has qualified, shall be deemed to have been rejected. There is no evidence that the trustee ever agreed to assume responsibility for the warranty obligations mentioned above.

Also, in his Finding of Fact numbered 16, the Referee provides us with a "literal" interpretation of the subcontract in regard to the bankrupt's warranty period. The evidence clearly demonstrates that the date of acceptance by the owner of the completed contract (which includes final payment by the owners) was December 11, 1964 (T. I. 12, 35; Trustee's Exhibit 3). Therefore the one-year warranty period would not begin until that date, and the Referee's finding in this regard, which apparently implies that the FHA might have been the "Owner", is not supported by the evidence.

8. There was no wrongful transfer of McKee's right of set-off.

The trustee has argued that the proceeds here in issue were

obtained by McKee after the bankruptcy, and therefore "the claimed set-off falls clearly within the prohibition of Sec. 68(b) of the act" (R. 48). In view of the provisions of Sec. 68(b), it appears that the trustee is contending that a right of set-off was transferred to McKee afrer the filing of the bankruptcy petition.

It is clear from the record that any debt owed Fike by appellants was owed both before and after the bankruptcy (even if not yet due), and was owed jointly and severally, or individually by McKee. McKee also owned its debt from Fike on the Lincoln Hospital project both before and after the bankruptcy, and still owns it. There has been no attempt to transfer to McKee a right of set-off after the filing of the petition, as claimed by the trustee, since McKee itself had a set-off or the right to assert same at the time of the bankruptcy by virtue of both owning and owing a debt involving the same party, Fike. Therefore, the prohibition contained in section 68(b) of the Bankruptcy Act does not apply.

The record demonstrates that there is nothing wrongful in the owners making final payment to McKee acting under the name of the "joint venture", and in the subsequent placing of the money in the Tucson House Construction Company bank account. McKee subsequently withdrew the money involved from one bank account and switched it into another to mechanically accomplish the set-off (T.I 29, 35-39, 43-44). For the trustee to thus argue (T.II 26-27) that McKee was a converter of funds is ridiculous. There is no valid reason why McKee, assuming it has a valid right of set-off, at any point in time could not choose to transfer a certain amount of money to itself from the Tucson House Construction Company account to set-off certain legal obligations owed to it by Fike in connecttion with the Lincoln Hospital project.

If McKee is not entitled to the set-off, then obviously it should add the $50,745.12 by some accounting procedure back to the amount owed Fike under the Tucson House subcontract. But to argue that by thus effecting the set-off that McKee has obtained

proceeds after the act of bankruptcy, and therefore is not entitled to a set-off is to argue in circles. By hypothesis, if McKee is entitled to the set-off, then its mechanical transfer of funds does not amount to obtaining proceeds after bankruptcy, and therefore the provisions of section 68(b) would not be applicable.

9. Reliance Insurance Company's interest does not detract from the validity of McKee's right of set-off.

From the very beginning of these proceedings the trustee has attempted to inject the ugly spectre of Reliance Insurance Company as the "real party in interest", and has tried to picture McKee as an unwilling "front" or "conduit" for Reliance (R. 62). McKee's version of the indemnity agreement (Trustee's Exhibit 10) has been reiterated before (Argument III; see also T. II 35-36), and it has been admitted by the trustee that the crucial issue in this lawsuit is whether or not McKee, (not Reliance), has a right of set-off.

Although it is indicated in Findings of Facts numbered 18 and 19 that the real party in interest herein is Reliance Insurance Co., no foundation is given for arriving at such a conclusion. Conclusion of Law numbered 1(d) similarly states that Reliance Insurance Co., which is not a party to these proceedings, is the "real party in interest." The words "real party in interest" are words of legal art and refer to the person who is denominated as the plaintiff, claimant or petitioner. If Reliance Insurance Co. is in fact the real party in interest, then why wasn't it made a party to these proceedings?

The fact that Reliance Insurance Co. has something to gain by the allowance of the set-off has no proper materiality to the outcome of this lawsuit. For that matter, all of Fike's creditors have something to gain if McKee is made to pay Fike's claim in full, while receiving only a partial return on its claim. The only purpose for the above Conclusion is a "bootstrap" attempt by the Referee to obtain summary jurisdiction (T. II 22-25), based on the fact that Reliance has filed a claim in these proceedings; and

this purpose has subsequently been rendered moot since appellants have consented to summary jurisdiction.

Appellants are not proceeding under a subrogation theory as the trustee would have the Court believe (R. 149; see also Argument II). Appellants deplore the trustee's continued attempts to create sympathy for his cause by labeling Reliance as the bogeyman in these proceedings, and by attempting to point out that Reliance will secure some imagined benefit for its vile scheme. The important and only material issue to consider is that *McKee has a bona fide right of set-off to which it is entitled,* and this is true irrespective of the bonding companies involved.

10. McKee has suffered additional warranty expenses on Tucson House.

The Referee found that McKee had incurred expenses in the amount of $2,765.45 in payment of Fike's unpaid materialmen's claims in connection with the Tucson House project. In addition, the Referee found that McKee had expended a total of $1,375.87, exclusive of the lien bond premium (Respondents' Exhibit 10), in performing Fike's warranty obligations up to September 20, 1965, the date of the hearing before the Referee.

Since the above date, and prior to the expiration of the one year warranty period (T. I 78), calculated by appellants to be December 11, 1965, other charges have been made against Fike's account for warranty obligations, which amounts have heretofore not been presented to the Court. These additional sums amount to $1,517.92, for which McKee has proper invoices and substantiating documents. At the present time McKee calculates it has on hand some $2,515.59 credited to Fike's account on the Tucson House project, which sum McKee stands willing to turn over to the trustee when properly ordered to do so.

11. No interest should be allowed the trustee prior to December 11, 1965.

The Referee's order allows the trustee interest, on the sum

ordered to be turned over, to run from January 11, 1965. This date is in error since appellants have demonstrated, and the Referee has apparently conceded in his Finding of Fact numbered 17, that McKee had the right to retain the retention proceeds for the life of the warranty of one year, or until December 11, 1965. Clearly no interest can be charged to appellants for any period prior to December 11, 1965, which is the earliest date McKee could have, with National Surety's consent, turned over any money.

The trustee's argument (T. II 11; R. 65), apparently adopted by the Referee and the District Court, begins with the fact that the subcontract on Tucson House provided that the one-year warranty commenced on "the date of acceptance by the Owner of the completed contract." The trustee argues that since the evidence shows that acceptance took place in February, 1964 when the Owner[16] took occupancy of the premises (Footnote 17 in R. 65), and certainly by July, 1964 when the FHA accepted the project as 100 percent complete, that therefore the one-year warranty commenced in February, 1964.

Neither the trustee nor the Referee has ever explained why the date of January 11, 1965 was chosen as the date upon which Tucson House Construction Co. must begin paying interest. It is also obvious that the trustee has ignored that part of the subcontract provision quoted above which speaks of the warranty commencing after the *completed contract.* The contract was not completed until final payment was received from the owners on December 11, 1964, and therefore no interest could reasonably be charged appellants prior to December 11, 1965. Of course, if appellants are correct in their contention that McKee has a bona fide right of set-off, then no interest would be legally chargeable to appellants, and this question would become moot.

---

[16] Now it appears that the trustee is talking about the beneficial owners, Robbins and Schiff.

12. The trustee is not entitled to an attorney's fee in this matter.

The Referee has ordered, and the District Court has concurred, that a reasonable attorney's fee in this case be set, for services rendered to date, at $5,500. There is absolutely no evidence in the record to support such a finding, as at no time did the attorney for the trustee attempt to present any evidence bearing on the question of attorney's fees. In fact, the record shows that the trustee's attorney rested without putting on any evidence of attorney's fees (T. 1 89). At the September 20, 1965 hearing Mr. Jacobowitz, the trustee's attorney, stated as follows:

> "Your Honor, with the exception of the matter of attorney's fees, upon which we do not propose to present evidence at this time, we rest."

The Supreme Court of Arizona has stated that in order for attorney's fees to be awarded, there must be some evidence in the record supporting such an award. *Crouch v. Pixler* (1958) 83 Ariz. 310, 320 P.2d 943; *Mason v. Mason* (1945) 108 Utah 428, 160 P.2d 730; *Muckle v. Hill* (1920) 32 Idaho 661, 187 P. 943; *United States Fidelity & Guaranty Co. v. Zidell-Steinberg Co.* (1935) 151 Ore. 538, 50 P.2d 584, 51 P.2d 687; 7 *Am. Jur., Bills and Notes,* § 142, p. 869.

In addition, appellants contend that the bankruptcy court was without jurisdiction to make such an award for the reason that such power is not granted to the Referee under summary jurisdiction authority. A careful analysis of the Referee's decision discloses that the turnover is ordered not because appellants owe Fike money under the subcontract, but because the money came into the constructive possession of Fike before appellants came into possession. The only basis upon which the Referee can award attorney's fees, assuming he has jurisdiction, would be through the failure of the appellants to pay the monies due Fike *under its subcontract.* It is clearly the law that the bankruptcy court does not have summary jurisdiction to collect debts owing the bankrupt,

especially when the Court attempts to found its award on an imagined "trust theory."

CONCLUSION

Appellants have attempted to show that the evidence and the law in this case is sufficient to establish the requisite mutuality to allow the appellant McKee to effect its right of set-off. For the reasons stated, it is respectfully submitted that the District Court's Order affirming the Referee's Turnover Order be reversed, that McKee's right of set-off be established, that the warranty period be established as expiring not prior to December 11, 1965, that the trustee be denied attorney's fees, and that the cause be remanded with instructions to fix the exact amount owing to the trustee.

JENNINGS, STROUSS,
SALMON & TRASK

By William F. Haug
T. Patrick Flood
111 West Monroe
Phoenix, Arizona 85003
Attorneys for Appellants

August, 1966

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

William F. Haug

(Appendix Follows)

APPENDIX

TABLE OF EXHIBITS

Exhibit No.	*Description*	Page number of T. I where identified	Page number of T. I where admitted
Trustee's No. 1	Tucson House Construction Contract	3	53
Trustee's No. 2	Tucson House Joint Venture Agreement	4	53
Trustee's No. 3	Tucson House Subcontract	6	53
Trustee's No. 4	Tucson House Surety Bond	7	53
Trustee's No. 5	Lincoln Hospital Surety Bond	9	53
Trustee's No. 6	Fike's Notice and Claim of Lien re Tucson House	10	53
Trustee's No. 7	Letter dated November 17, 1964 from McKee to Fike	13	53
Trustee's No. 8	Letter dated December 5, 1964 from McKee to National Surety Corporation	15	53
Trustee's No. 9	Letter dated January 22, 1965 from attorney for Trustee to McKee	16	53
Trustee's No. 10	Indemnity Agreement dated February 10, 1965	16	53
Trustee's No. 11	Letter dated February 12, 1965 from attorney for Reliance to National Surety Corporation and McKee	18	53
Trustee's No. 12	Prototypes of checks used by Tucson House Construction Company re Tucson House	19	53
Trustee's No. 13	Letters dated September 13, 1965 and September 14, 1965 from attorney for Trustee to attorneys for Appellants	20	53

TABLE OF EXHIBITS (Continued)

Exhibit No.	Description	Page number of T. I where identified	Page number of T. I where admitted
Trustee's No. 14	Extracts from Answers to Interrogatories by appellant McKee	21	53
Trustee's No. 15	Checks # 187-189 dated February 15, 1965	36	53
Trustee's No. 16	Letter dated February 11, 1965 from attorney for Trustee to McKee	45	53
Trustee's No. 17	Letter dated February 16, 1965 from McKee to attorney for Trustee	83	83
Respondents' (Appellants') No. 1	Letter dated July 31, 1964 from National Surety Corporation to McKee	66	67
Respondents' (Appellants') No. 2	Letter dated June 1, 1964 from McKee to National Surety Corporation	70	70
Respondents' (Appellants') No. 3	Tucson House General Contract Bond	108	109
Respondents' (Appellants') No. 4	Letter dated December 4, 1964 from McKee to National Surety Corporation	109	111
Respondents' (Appellants') No. 5	Letter dated December 16, 1964 from National Surety Corporation to McKee	109	111
Respondents' (Appellants') No. 6	Letter dated December 5, 1964 from McKee to National Surety Corporation	109	111
Respondents' (Appellants') No. 7	Lincoln Hospital Construction Contract	111	112
Respondents' (Appellants') No. 8	Lincoln Hospital Subcontract	113	113

TABLE OF EXHIBITS (Continued)

Exhibit No.	*Description*	Page number of T. I where identified	Page number of T. I where admitted
Respondents' (Appellants') No. 9	Letter dated November 13, 1964 from McKee to Fike	114	114
Respondents' (Appellants') No. 10	McKee's accounting work sheet re Tucson House	114	115
Respondents' (Appellants') No. 11	McKee's work sheet re liens on Tucson House	121	124
Respondents' (Appellants') No. 12	Lien Release Bond re Tucson House	122	124